Vertical Restraints: What About the Evidence?

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Movement Toward Effects-Based Analysis of Vertical Practices

- 1977 Sylvania Decision.
- EU Article 81 Block Exemption Regulation.
- ➔How do we draw inference about effects of contracts between manufacturers and retailers (RPM, exclusivity, loyalty discounts, bundling, refusal to deal)?

Two Ways to Infer Effects

- Natural experiments
  - Control group (without restraint)
  - Experimental group (with restraint)
  - Does experiment mimic effect of restraint?
- Model-based inference
  - Posit anticompetitive theory
  - Post procompetitive alternative
  - Which is best supported by evidence?

What Are Anticompetitive Theories?

- In a regulated industry
  - Regulatory evasion
  - Get government to raise rival's cost
- In an unregulated industry (focus of talk)
  - Softening horizontal competition.
  - Multilateral opportunism.
  - Dynamic entry/exit/investment effects.

What Theory Tells us

- There is possibility that vertical restraints harm competition
  - But no way to tell when harm is likely
- Harm occurs in same instances where restraints likely to have efficiencies.
  - Mistakes likely
- ➔The "possibility theorems" do not give us practical ways for distinguishing pro-competitive from anti-competitive effects.

What about the Evidence?

- Little empirical evidence testing specific theories.
- But, growing body of evidence from “natural experiments.”
  - Control Group (with restraint)
  - Experimental group (without restraint)
- Find that Vertical Contracts and Vertical Integration
  - Reduce price
  - Induce demand-increasing services

Representative Evidence

- *Gasoline*: prices 2.7¢/gallon higher in states with vertical divorcement laws
  - Vita and Sacher (2000)
- *Beer*: UK divorcement of "tied" pubs raised price
  - forced to offer the beer of at least one rival brewer.
  - Slade (1998).

Vertical Restraints Solve Double Markup Problem

- ***Gasoline***: vertical integration reduces prices by $0.03/gallon; [Vita, 2000; Barron et al., 2004; and Barron & Umbeck, 1984 & 1985; Shepard,1993]
- ***Beer***: UK "beer orders" reducing vertical control of pubs resulted in higher retail beer prices, [Slade 1998]
- ***Cable TV***: integration of cable TV programmers with distributors lowered retail prices [Chipty, 2001]
- ***Various***: 30% of litigated Resale Price Maintenance cases involved **maximum** RPM [Ippolito, 1991]
- ***Fast Food***: Prices are higher in franchised fast food restaurants as compared with company-owned stores [Lafontaine 1995; Graddy 1997/]

Vertical Restraints Increase Investment & Services

- Ippolito (1991) and Ippolito & Overstreet (1996) found that RPM generally consistent with demand-increasing activities
- Sass & Saurman (1996) found that ban on exclusive territories in beer sales reduced beer consumption by 6%.
- Mullin & Mullin (1997) found vertical integration induced investment in relationship-specific assets in steel production.
- Hersch (1994) found evidence consistent with efficiency rationale for RPM.

What about Anticompetitive Theories?

- "Post Chicago" economists constructed ***theoretical*** examples of harm caused by
  - Raising Rivals' Costs
  - Softening Competition
  - Multilateral Competition
  - Agency Theory
- But what is the evidence?

Evidence of Anticompetitive Vertical Theories?

- Various: Gilligan (1986) finds negative abnormal returns upstream when RPM contracts challenged.
  – Consistent with efficiency and manufacturer cartel.
- Cable TV: Ford and Jackson (1997) find vertical integration ➔ small losses in consumer welfare ($0.60 per subscriber per year).
- Cable TV: Waterman and Weiss (1996) found that cable systems that owned pay movie channels were less likely to carry rival pay channels
  – consistent both with pro- and anticompetitive behavior.
- Gasoline: Hastings (2004) found rivals of acquired gas stations raised prices post-acquisition, but that the tendency to raise prices did not depend on the vertical structure of the rival station.
  – Price increase attributed to "branding" formerly "unbranded" retailers

Summary of Research

- Most studies find evidence of efficiencies from vertical practices.
  - Elimination of double mark-ups and/or cost savings.
  - Dealer services efficiencies.
- Evidence "consistent with" anticompetitive effects is generally ambiguous and inconclusive.

Policy Responses to Enforcement Uncertainty

- Screens
  - Work only in certain instances
  - But conditions for market power are often same conditions as those for efficiencies
- Lesson from empirical economics
  - Find good natural experiment:
    - Before and after restraint
    - Compare markets with and without restraint

FAQ's About Merger Simulation

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Isn't merger simulation built on unrealistic assumptions?

- Behind every competitive effects analysis is an economic model.
  - Simulation makes the model explicit
  - Forces economists to "put cards on table"
- Every model makes unrealistic assumptions
  - Crucial question is whether model ignores factors that lead to biased predictions

Has merger simulation been tested against real data?

- No methodology has been shown to predict effects of real mergers
  - No coordinated effects theory,
  - No unilateral effects theory,
  - No market concentration theory.
- Model should be judged by how useful it is
  - Does it focus investigation?
  - Does it capture current competition?

Is merger simulation worth the money?

- *Demand estimation* is often expensive, open ended, yet can yield very little.
  - Often done without simulation, e.g., Kraft
- Merger simulation does NOT require demand estimation.
  - Can be done quickly, with very little information
- Virtue of simulation is focusing investigation on facts and assumptions that matter

Does merger simulation sway decision-makers at agencies?

- Merger simulation is a standard methodological tool
  - No tool is definitive.
  - Used to organize evidence, not to substitute for it.
- First used in 1994 in US v. IBC
  - Expert declaration published in Int'l J. Economics of Bus. with five other examples from real cases.
- Use in recent litigated cases
  - Lagardere; Oracle/Peoplesoft;

Doesn't simulation always predict a price increase?

- Every anticompetitive theory predicts price increase
  - We have safe harbors for concentration
- Use simulation to organize evidence, focus investigation, benchmark efficiency claims, evaluate remedies.
  - Can compute cost reductions that offset price increase.